DOW THEORY LETTERS INC.

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THE MARKET: Evidence continues to suggest that the economy is heading for trouble. In its latest report, the First National City Bank (N.Y.C.) notes that (1) After-tax profits of 1449 corporations (whose results are tabulated regularly by the Bank) dropped 12% from the second quarter to the third. (2) Profits margins (i.e. profits as a percentage of sales) declined from a second quarter 7% to a third quarter 6.1%. (3) Business reports of the past month, states the Bank, "continued to show a slowdown in the civilian sectors of the economy." As I write this, news has come out that new housing starts have dropped to an annual rate of 848 thousand, the lowest level in 21 years. At the same time, all four auto stocks have dropped to new lows for the year--with General Motors cracking the critical 70 level. By next year the nation could be in the midst of a combined auto-housing slump. In my opinion, 1967 could witness severe financial troubles with our two greatest civilian industries (autos and housing) in poor shape.

Meanwhile, back on Wall Street the primary bear market is in the process of mounting its best rally of 1966. As of this writing, the Industrials have retraced 30% of the 251 points lost between February and October. On September 15 the Rail Average bettered its September high, thus confirming the prior penetration of the Industrials. Is this the signal for a new bull market, I am asked? My answer is no. First, the September highs did not represent points of secondary significance (I took the September advance to be merely a rally, not a full secondary upward correction. Secondly, I would be most wary of declaring "a new bull market" after only 8 months of bear market action following the greatest bull market (1949-1966) in history.

Remember, I have been stressing that this bear market is now in the early part of its second phase. I would want the completion of the second phase and the emergence of the third phase before looking for a new bull market signal. The second phase is almost always the most treacherous phase of a bear (or a bull) market. I want subscribers to remember this: A bear market will try to break you financially if it can. It will fool you, it will produce deceptive movements, it may well provide "false" bull signals. The phase analysis is crucial in determining the primary trend of the market. Those who are searching for "bull market signals" during the second phase of this primary bear market are playing with "financial fire."

This bear market shows every sign of being a long, dragged out affair. Those who embrace a shallow psudo-Dow Theory approach in analyzing this market are going to hurt, in my opinion, during the period ahead. Primary reversals do not arrive "in a day" as did the

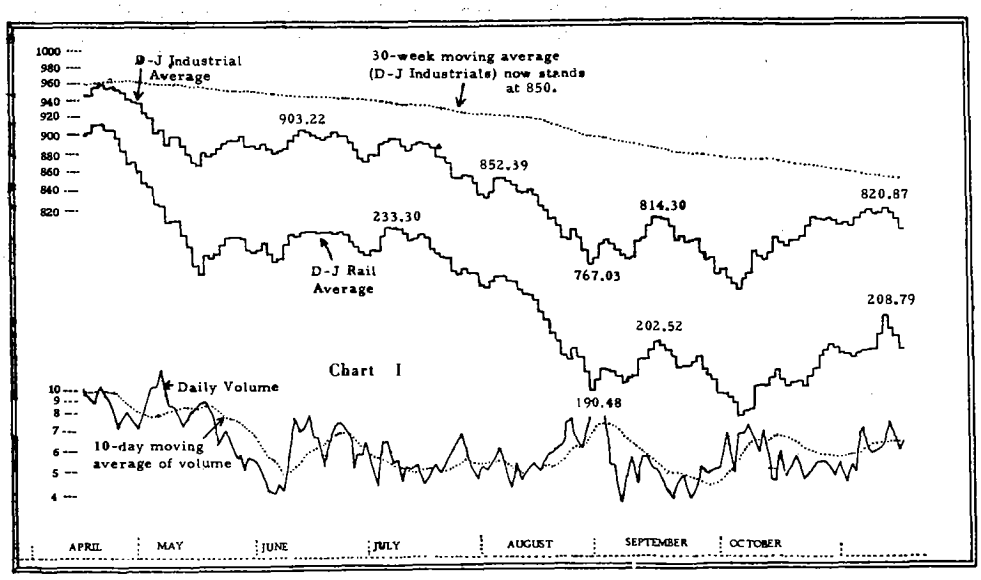
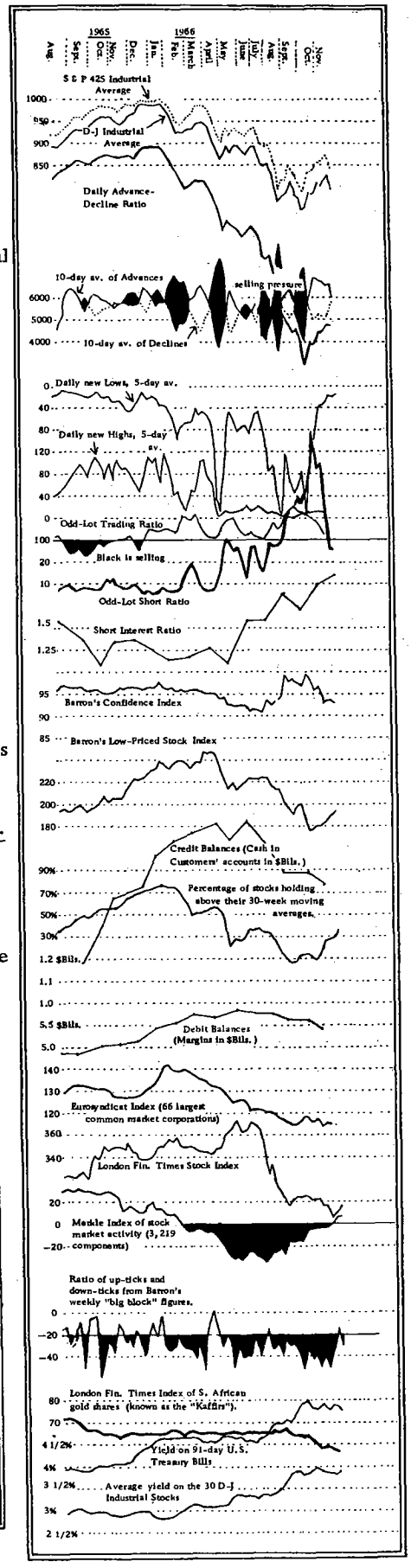


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

reversal at the October lows. Therefore, the present rise is most likely to be a deceptive correction within a primary bear market. If so, new lows will be seen during the period ahead. It is simply a matter of time.

* * * *

How does the long-term investor, the individual who is interested in investing in harmony with the primary trend, adjust his thinking to the current action? Last week I spoke to a gentleman who I consider to be one of the very few authentic geniuses of Wall Street. This man has been right on the primary trend of the market ever since the 1940's (when he first started operating on Wall Street). He made a fortune during the 1949-66 bull market. He sold out during 1965-66, and he now believes that the great 1949-66 bull market is over. Here is what he told me: "The market is in a major primary bear trend. We are now in the process of correcting all the ills, excesses and profligacies of the last 17 years. I believe that a major bear market started in February, 1966, and that the current bear market will last for perhaps 3 to 5 years. If this bear market erases only half of the gains of the preceding bull market (161.60 of 1949 to 995.15 of 1966) we will go back to about 578 on the Dow. But I believe that we could easily wipe out more than half of the 1949 to 1966 gains.

NOTES & QUOTES: From the latest Janeway Service (311 E. 50 St., N.Y.C.). "The overall economy is rejecting LBJ's experiment with a Guns-and-Butter compromise short of war taxes and controls. The first such experiement failed in War II because the war got too big to allow it. The most recent experiment failed during the Korean War for a different reason, unrelated to the size of the war as such, but because of our 1950 plan for expanding the economy to make it capable in the future of fighting a jungle war without domestic disturbance: the "Defense Support" program, which didn't bring new capacities on stream until the fighting was over, got too big to support Guns-and-Butter.

"In this war, escalation is becoming too costly and the economy is getting caught in too tight a money squeeze to support the experiment - in the private sector: witness the admitted need for war taxes and the start-up pressure for controls. But in the government sector, Guns-and-Butter spending is here to stay, very much on a business as usual basis, and getting bigger all the time. In fact, the angrier the frustration over the war gets, the bigger the build-up in governmental expenditures at all levels, unrelated to the war, will be. The revival of inter-party competition, far from slowing it down as per popular post-election speculation, will now speed it up. The bond market will be the principal casualty of the continuing Guns-and-Butter spending surge. The stock market should not be expected to get out from under bear market pressure while the bond market is still subject to it."

* * * *

I have just finished reading the completely fascinating autobiography by that titan of the 19th Century, Daniel Drew. Title, "The Book of Daniel Drew" published by American Research Counsel, Larchmont, N.Y. Drew is one of the most powerful and intriguing figures in Wall Street annals, and his struggles with "the Commodore" (Cornelius Vanderbilt) shook the Street and the nation for decades. Here's a quote from Drew which I could not resist inserting for my readers:

"Another difference between the Commodore and me was that he was by make-up a bullish fellow, whereas most of my life I have been on the Bear side of the market. It used to be one of his mottoes: 'Never sell short.' Even in the darkest hours of the Civil War, he had lots of faith in the future of the country. He seemed to think that in America 'most any kind of stock would go up and be valuable if he only waited long enough. 'I bide my time,' he used to say to me, when I would tell him he'd better sell such and such a stock and get it off his hands. 'Get it off my hands?' he'd exclaim. 'Not by a jugful! I bought that stock as an investment; it's going to reach par some day, and don't you forget it.'

"Yes, he was a natural-born hoper. I have always been more conservative - have never allowed myself to paint the future in too bright colours. The Commodore made most of his money by stocks going up. I made most of mine by stock going down. I wish now I'd been a Bull instead of a Bear. Because a Bull makes money when everybody's happy, that is, when stocks are on the upward move; so that people are willing to see him get rich. But a Bear makes his money when other people are unhappy. Because, in order for him to make, others have got to lose; for him to get rich means that there is a line of bankrupts in his train; and people cuss him so for taking money away from them, that his fortune doesn't give him so very much satisfaction."

"As for a new bull market having started last month at 744.32 on the Dow, my advice is to 'forget it'. Why do I say that? First, it is not logical to expect a new bull market to start after only 8 months of bear market action. Nothing has really been corrected yet in point of time. Second, the February to October drop was really no greater, in percentages, than the 1962 drop. And that was only a reaction in a continuing bull market. I would expect this bear market to carry far further on the downside than the 1962 bull market reaction did.

"Third, the long-term trend of odd-lots continued heavily on the buy-side all through October. No primary bull market in history started under such conditions.

"Fourth, the cash yield on the Dow was only 4.03% at the October lows. At true primary bear market bottoms the yield on the Dow should be nearer 6% to 8%. The Dow was not a great value at the October lows. It was only 'cheap' when compared with the prices which existed at the February high. Fifth, mass psychology was far too bullish during October to suggest that we were in the area of a major bear market bottom. Why people never really got pessimistic on the whole February to October decline. The absence of any 'panic-type' action proves that.

"Sixth, debit balances (margin accounts) are currently just off their all-time highs--even though they are declining. If this was a real bear market bottom, I would have expected margins to have been substantially liquidated as they were at the previous great bear market bottoms of 1938, 1942, and 1949. Seventh, volume was much too high during October to suggest a real bottom. In fact, average 10-day volume never broke below 5 million at the October low. But in past bear markets volume usually drops (at the final bottom) to about 10% of that which existed at the previous bull market peak. In other words, at the final bottom I expect to see daily volume in the 1 to 2 million share per day class, rather than 5 million shares per day which we saw in October, 1966.

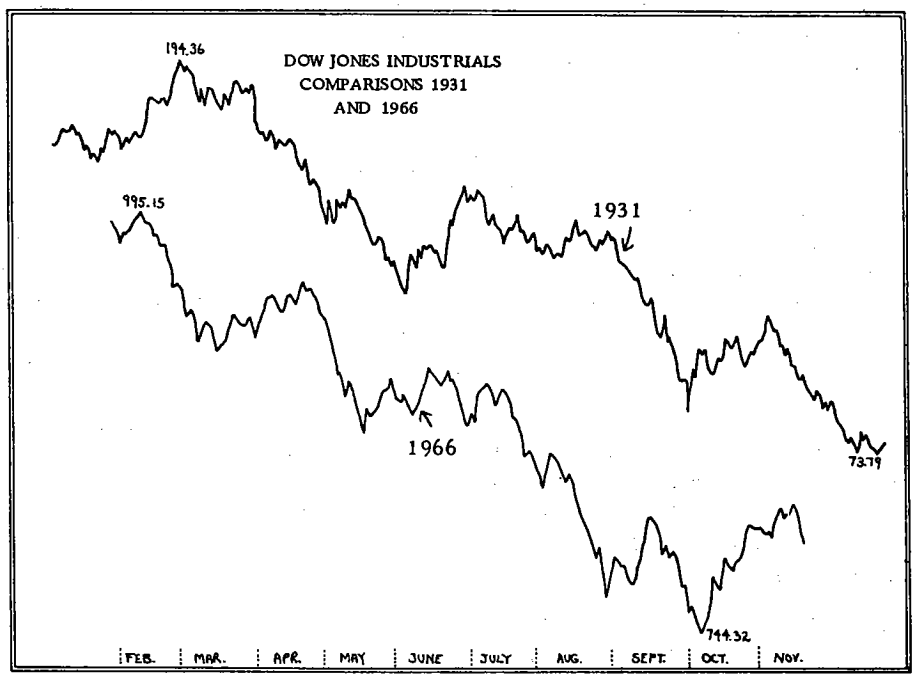
"Let's sum it all up this way: I believe that we are still in a primary bear market. Currently, we are witnessing a full upward correction, but sooner or later this correction will blow itself out. When that happens, the primary bear trend will resume. And if I am correct, if the primary bear force is still in effect, then by definition (following the completion of this secondary) we will witness a new decline and ultimately new lows on both Averages.

"You see, most investors get caught up in the ripples and the waves; they don't see the tide. But it is the tide which makes or breaks you in this business. You may be right on one secondary correction, but the odds are that the next one will get you. Playing secondaries

is a very tricky business, in my experience. But I know one thing, if my thesis is correct, if a primary bear tide is still in force, then we can expect new lows by perhaps the end of this year or by sometime next year. And that is what interests me. That's what is going to guide my investment policy. So I'll be patient. Let the 'in-and-out' traders make the money on this rise. I make my money on the primary trend--in long-term positions."

I have paraphrased what this gentleman said at length because I happen to agree with him, and because this is what I have been telling my own subscribers all along--in Letter after Letter. The man who stays with the primary trend may look very wrong during secondary (upward) reactions within a bear market, but in the end he is going to be right. And in the final analysis he is not going to get hurt. If you guess wrong only twice and lose say 15% of your capital during each guess in the course of a bear market, you have lost one-third of your money. It does not take many wrong guesses in the market to break you!

So for the great majority of my subscribers, I repeat that I believe you should exercise patience, you should "out-wait" the ripples and daily and weekly counter-trend movements, and you should save your hard-earned capital for the real bear market bottom. I don't make the market, I don't decide when the bottom will come. But I will do my best to identify it when it does arrive. In my opinion, it may take a year, it may take a few years, but we have not yet seen the end of this bear market yet. None of the criteria I use suggest that the end came last October at 744.32 on the Dow.



COMPARISON: I have drawn an overlay chart (the time periods correspond exactly) for the bear market year 1931 and the current bear market year 1966. The comparisons are most interesting. Note the definite "rhythm" of the rallies and declines in both years. This is in sharp contrast to the sudden rapid bull market reaction collapses of such years as 1957 and 1962. Next, note the deceptive and sudden "tops" of the rallies during 1931 and 1966. The rallies end with little or no warnings, and the subsequent crashes to new lows are swift and unexpected. Also, study the distribution following each rally top during 1931 and 1966. Distribution following the rally tops is extended and tedious, and each distributive area is followed by a sudden collapse.

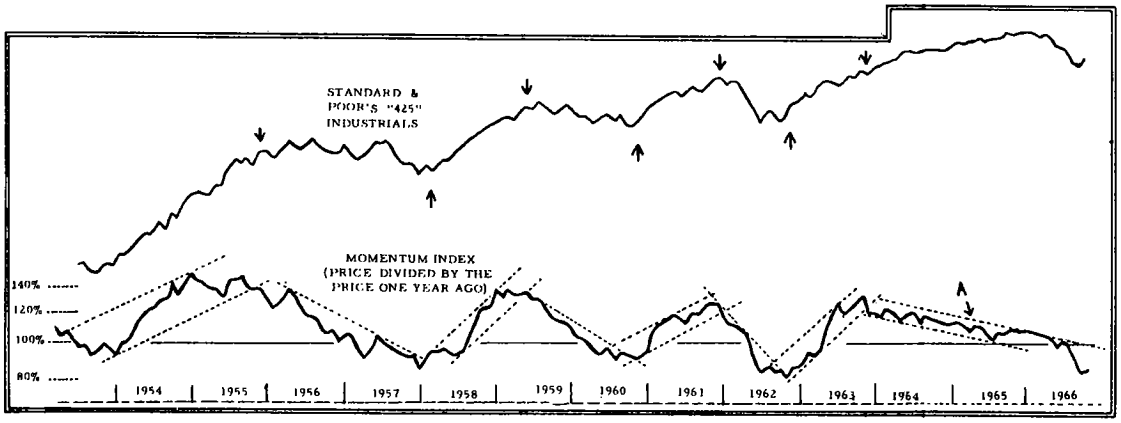
The action of the market during 1966 is really different than anything seen in this generation. It is closer to the action of 1930, 1931 and 1932 than to any other years on the charts. This is not to imply that we are now on the brink of a catastrophic period such as the Great Depression of 1929 to 1932. But I feel that it does imply primary bear market action in 1966, rather than secondary corrective action such as in 1962. I also believe that it will be helpful for subscribers to study and get familiar with the way upward corrections occur and terminate during a primary bear market. Based on the pattern this year and the pattern during 1930 and 1931, I would think that the current upward movement will end suddenly and with little warning. There will then be a deceptive period of backing and filling (distribution), followed by a violent collapse to new lows on the Averages.

MOMENTUM: One of the indices which I watch carefully is the momentum index (MI). The MI is reviewed here every few months or whenever I believe it is saying something significant. There are many variations on the MI, but the one I use is based on the ratio of the price of the Standard & Poor 425 Industrial Average with its price exactly one year ago (end-of-the-month prices are used). Thus the MI is simply the price of the 425 as a percentage of its price a year ago.

The chart on page 4 shows the MI for a period of 14 years--from 1953 to the present. Actually my office chart goes back to 1926, so I do have a long history of this valuable index. Note that the MI tends to move within extended channel formations. Since 1953 eight distinct channels (each representing a change in direction) have been traced by the MI. I watch three factors in the MI: (1) the direction of the index, (2) whether the index is above or below 100, (3) the point at which an established channel is penetrated in the opposite direction by the MI, and this latter is what represents a trend change.

The arrows on the chart signify the point at which "channel breakouts" or trend reversals were recorded. Market tops usually take much longer to build than bottoms, and it is for this reason that changes in market direction usually arrive much more quickly following "up-arrows" on the charts than is the case following "down-arrows." Note, for instance, the long elapsed period following

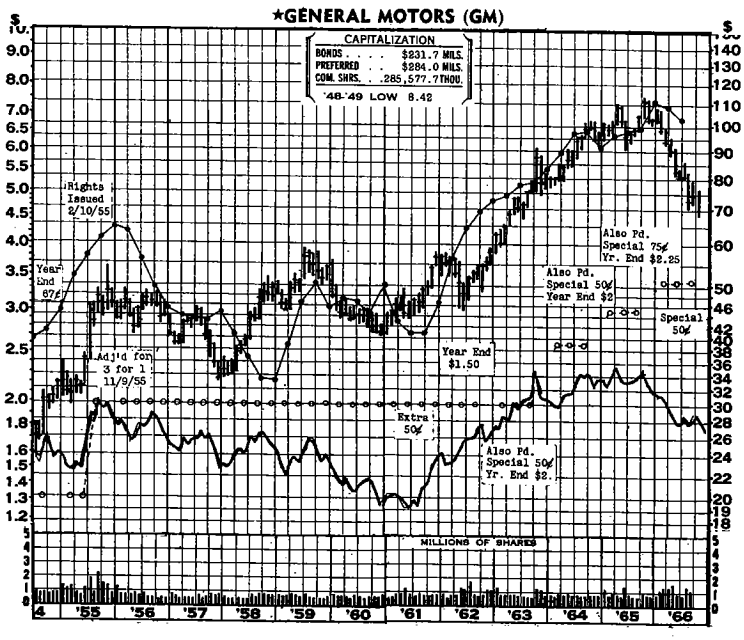
the down-arrow of 1955 and the latest down-arrow of late 1963 (October). In fact, if we consider that the market turned decisively down in February, 1966, this latest "bear signal" on the MI constitutes the longest lapse time between a down-signal and a decisive down market in the 40-year history of the MI.



As a rule, when the MI is holding within a downward channel the situation calls for caution. Whenever the MI is below 100 (in other words, when the S&P 425 is below its price of one year ago) the situation is bearish. During a bear market, it is not unusual for the MI to hold rather consistently below 100 for months on end.

The latest reading for the MI (based on a preliminery mid-month figure) is 89. This means that the MI is still holding well within the current descending channel. Here are my guesses as to what to expect and look for in the MI during the period ahead. Based on the action during past bear markets, I would guess that the MI will hold generally below the upper trendline ("A" on chart) of the current descending channel throughout this bear market. Except during major and extended upward corrections, I would guess that the MI will hold below 100 for the duration of this bear market. Finally, based on past action investors could have waited for decisive upward penetrations of down-channels before establishing new bull market positions. If this is true, then those who believe that a new bull market started in October (744.32 on the Dow) would nevertheless do well to wait for a channel reversal on the MI before buying. Such a reversal has not yet occurred and probably could not occur for another month or so. In other words, the MI is saying "if you are bearish the MI continues to fortify your bearish stand. If you are bullish, it would still pay you to wait for a reversal on the MI."

STOCKS: I have been talking a good deal about the weakness in motors, but there is no question about it--the current weakness is very significant. On Friday, November 18, all four motor stocks (Ford, GM, Chrysler, Am. Motors) broke to new lows for the year. That weakenss was followed up Monday by further weakness in the motor stocks and in the rest of the market.



I have included a long-term chart of GM, because I want subscribers to see exactly what is happening in this most significant of all American corporate entities (chart from Securities Research, 208 Newbury St., Boston, Mass.). Here we see a giant distributive formation in GM, a distribution which in time extends over a period of 18 months. In April of 1966 the formation can be said to have "cracked." During that month GM smashed through its major bottom at 90. GM then dropped almost uninterruptedly to 70 3/8, the new base. After holding above 70 3/8 since last August, GM weakened again. This week finds the stock in the 68 area, and if we examine the chart we see that there is no real support for GM until the 1959-1961 top area of 58.

Adding to the bearish picture for GM are (1) The fact that the weekly figures show that GM has been purchased by the odd-lotters consistently with purchases frequently outnumbering sales by a 2 to 1 or 3 to 1. Thus, the implication is that GM has been going into weak hands while strong hands distributed. (2) The relative strength line on GM has been sagging since early 1965 (lower line on chart). Recently, GM's relative strength line has dropped to its lowest level since late 1962. The fact is that the motor stocks are now dropping out of favor with investors. Informed interests see trouble ahead for one of America's greatest industries. My own guess is at the 1965 highs, the motors had established peaks which will hold for many years to come. Over the past few years the motor group had reached its highest level of relative strength in history. It may be a decade or more before this group comes back into great investor favor again.

NOTE: Again I want to apologize to readers for the fact that I simply cannot answer all the mail which is sent to me. I do try to put as much of general interest in the Letters as possible, but I cannot possibly answer all my subscribers' mail and do a good job on Dow Theory Letters. It often takes as much psychic energy to write an intelligent response to a personal letter as it does to write a whole section of the report. I know that other reports are often "staff-written." However, I write every word of Dow Theory Letters myself, and this means I have just so much time to devote to other things. Please excuse me, dear letter-writers. I read your every word, but I have had to give-up answering except in rare instances.